

FEDERAL HOUSING FINANCE BOARD

OPEN BOARD OF DIRECTORS MEETING

Washington, D.C.

Wednesday, November 8, 2006

ANDERSON COURT REPORTING
706 Duke Street, Suite 100
Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

1 PARTICIPANTS:

2 Board Members

3 RONALD A. ROSENFELD, Chairman

4 ALICIA R. CASTANEDA

5 GEOFFREY S. BACINO

6 BRIAN MONTGOMERY

7 ALLAN I. MENDELOWITZ

8 Also Present

9 SHELIA S. WILLIS

10 JOHN P. KENNEDY

11 STEVE CROSS

12 JONATHAN LINDLEY

13 CHRIS BOSLAND

14 BILL GLAVIN

15 CHARLES JONES

16 DARIS MEEKS

17 J.P. GREEN

18 Presenters

19 JIM SHANNON

20 JOSEPH MCKENZIE

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1 P R O C E E D I N G S

2 (10:01 a.m.)

3 CHAIRMAN ROSENFELD: Good morning,
4 everyone. I call this meeting of the Board of
5 Directors of the Federal Housing Finance Board to
6 order. Today we will have an open session with
7 one announced item, a staff briefing on the
8 Federal Home Bank of Chicago's request to redeem
9 excess stock. Before we turn to that item, I move to
10 add a second item because the Finance Board's
11 business so requires. The item is a staff
12 briefing on the Federal Home Loan Bank's Combined
13 Financial Report for 2005 which was posted early
14 this morning on the Office of Finance's Web site.
15 No earlier notice of this change was possible. Is
16 there any discussion of the motion? Do I have a
17 second for the motion?

18 DIRECTOR BACINO: Second.

19 CHAIRMAN ROSENFELD: Thank you, Director
20 Bacino. The secretary will please call the roll
21 on the motion.

22 SECRETARY WILLIS: On the item before the

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1 Board, Director Bacino, how do you vote?

2 DIRECTOR BACINO: Yes.

3 SECRETARY WILLIS: Director Castaneda?

4 DIRECTOR CASTANEDA: Yes.

5 SECRETARY WILLIS: Director Mendelowitz?

6 DIRECTOR MENDELOWITZ: Yes.

7 SECRETARY WILLIS: Director Montgomery?

8 DIRECTOR MONTGOMERY: Yes.

9 SECRETARY WILLIS: Chairman Rosenfeld?

10 CHAIRMAN ROSENFELD: Yes. The motion is

11 carried, and now let us move on to the first item,

12 the Chicago Bank's request to redeem excess stock.

13 Who will be making the presentation? Jim?

14 MR. SHANNON: Good morning. Chairman Rosenfeld

15 and members of the Board, the matter brought before

16 you this morning is for information only and does

17 not require Board approval. On September 21,

18 2006, the Finance Board received a request for

19 redemption of an additional \$375 million in excess

20 stock from the Chicago Federal Home Loan Bank.

21 This request is consistent with the Chicago Bank's

22 previously announced and agreed to business

1 strategies which included a decrease in the amount
2 of excess stock.

3 The redemption process will follow the
4 already approved Capital Stock Redemption
5 Guidelines that were used in the June redemption.
6 The redemption request complies with governing
7 rules, regulations, and the applicable provisions
8 from the June 30, 2004, written agreement and the
9 three subsequent amendments.

10 Using preliminary October 31, 2006,
11 balance sheet information, the Bank's pro forma
12 leverage ratio was 4.8 percent, the amount of
13 capital stock in subordinated debt is \$3.61
14 billion, and excess stock is approximately \$925
15 million. Based on our review of the submission
16 and subsequent discussions with Bank staff, the
17 Office of Supervision and the Office of General
18 Counsel intend to approve, and I would be happy to
19 answer any questions you have on this request.

20 CHAIRMAN ROSENFELD: Do any of the Board
21 members wish to comment? Do you have any
22 questions?

1 DIRECTOR CASTANEDA: I do, Mister
2 Chairman. First, Jim, I appreciate the briefing
3 as well as the one-on-one briefing we had the
4 other day. Obviously we are limited here to what
5 we can discuss in this open meeting since the Bank
6 is still under the written agreement and the
7 issues are closely tied to confidential
8 supervisory and examination information.

9 I have two questions, and I just wanted
10 to make sure everybody understands. The Bank is
11 not asking this Board for approval to issue any additional
12 subordinated debt, right?

13 MR. SHANNON: No, this request is not
14 for any additional subordinated debt. This is the
15 retirement of excess stock.

16 DIRECTOR CASTANEDA: One of the goals we
17 have all had for the Chicago Bank is that the Bank
18 reduces its reliance on excessive stock. I'll
19 just mention to you that as of the end of October,
20 that number, did you say \$925 million?

21 MR. SHANNON: Approximately. After this
22 redemption it would be approximately \$925 million.

1 DIRECTOR CASTANEDA: Yes, precisely that
2 was what I was going to add. So by allowing the
3 Bank to redeem this \$375 million, the Bank is
4 going to be moving for the goal than we had which
5 is to reduce that reliance, right?

6 MR. SHANNON: Yes.

7 DIRECTOR CASTANEDA: In your opinion
8 then, there is nothing in the condition or
9 situation of the Bank or in its prospects that
10 would argue for a change or at least a temporary
11 suspension of our policy of encouraging the
12 Chicago Bank to continue reducing excess stock?

13 MR. SHANNON: At this point in time, the
14 Bank's plan as submitted in December 2005 and a
15 matter that we have discussed and reviewed with
16 the Bank's staff is moving forward as planned.

17 DIRECTOR CASTANEDA: Thank you.

18 CHAIRMAN ROSENFELD: Is there anything else?

19 If there is nothing else, let's move on
20 to the second item, a briefing on the Bank's
21 combined financial statement for 2005. Mr.
22 McKenzie?

1 MR. MCKENZIE: Good morning, Mister
2 Chairman and members of the Board. The Federal
3 Home Loan Bank's Office of Finance this morning
4 posted on its Web site the Combined Financial
5 Report for the 12 Federal Home Loan Banks for
6 2005. This report includes audited combined
7 financial statements of the 12 Banks. It marks
8 the first time the Combined Financial Report has
9 been provided since the second quarter of 2004.

10 The combined financial statements of the
11 Banks have been restated as of and for the years
12 ending December 31, 2003, 2002, and 2001, as a
13 result of restatements at 7 of the 12 Banks.
14 The effects of these restatements are reflected in
15 the annual report for the appropriate periods.

16 I want to add that the combined financial
17 statements for 2004 have not been restated because
18 they were never provided in the first place. A
19 number of the accounting adjustments that the
20 Banks needed to implement indeed were reflected in
21 the 2004 financial restatements.

22 As part of the process of registering a

1 class of securities with the Securities and
2 Exchange Commission, a number of Federal Home Loan
3 Banks needed to restate their past financial
4 statements. These restatements were primarily due
5 to technical misapplications and interpretations
6 of the Statement of Financial Accounting
7 Standards, number 133, Accounting for Derivative
8 Instruments and Hedging Activities, and arose
9 mainly from the rigorous accounting reviews
10 undertaken during the SEC registration process.

11 The majority of the Banks' hedges
12 involved in the restatements were highly effective
13 hedges and would have been eligible for hedge
14 accounting treatment had they been properly
15 documented at hedge inception. The net cumulative
16 effect of the restatements resulted in a \$168
17 million reduction in retained earnings as of
18 December 2004 of which approximately \$130 million
19 related to the reversal of cumulative unrealized
20 gains attributable to the hedge risk on certain
21 available for sale securities.

22 These securities were subsequently sold

1 and the gains recognized in earnings in 2005. Had
2 these securities been sold in 2004, the net
3 cumulative effect of the statements would have
4 been an approximate \$38 million or 2.2 percent
5 reduction in the retained earnings of that date.

6 In light of the then pending
7 restatements, corrections, and reclassifications,
8 the Office of Finance made the decision
9 temporarily to halt providing combined financial
10 statements, but as of August 8th of this year, all
11 12 Federal Home Loan Banks are SEC registrants and
12 the earnings restatements are complete for those
13 Banks that are needed to restate these past
14 financials. With the 2005 combined report, the
15 Office of Finance has resumed providing combined
16 financial statements.

17 We expect that the Office of Finance
18 next will provide a year end 2004 combined
19 financial report. Beginning in 2007, we expect
20 the Office of Finance to provide a combined annual
21 report each year by the end of March, and to
22 provide quarterly reports by May 15th, August

1 15th, and November 15th.

2 To provide a complete historical record,
3 we expect the Office of Finance to provide a
4 combined 2003 report that will include audited
5 financials for 2003, 2002, and 2001, and we expect
6 this report to be provided in the middle of next
7 year.

8 The Office of Supervision and the Office
9 of General Counsel will review the combined
10 financial reports for accuracy and completeness in
11 much the same way that the SEC reviews the annual
12 and quarterly financial report of SEC filers. I
13 would be happy to answer any questions you may
14 have.

15 CHAIRMAN ROSENFELD: Thank you very
16 much, Joe. I think it's appropriate to once again
17 mention the contribution of Director Castaneda in
18 the SEC process which I think is an integral part
19 of where we are today. It was a Herculean effort,
20 and we are all indebted.

21 I would also commend our Office of
22 Supervision, Office of General Counsel, and the Office of

1 Finance in what they have accomplished, which I
2 think although we are not really in competition, I
3 can't help but be a little bit competitive in
4 relation to the other GSEs and commend all of you
5 for our getting our financial house in order. Do
6 any other Directors have any comments?

7 DIRECTOR MENDELOWITZ: Yes, I wanted to
8 get a feel of orders of magnitude. The balance
9 sheet of the Home Loan Banks is about a trillion
10 dollars, correct?

11 MR. MCKENZIE: Correct.

12 DIRECTOR MENDELOWITZ: And secondly, all
13 the applications of the accounting rules that the
14 Banks use was done with the concurrence of their
15 external auditors at the time they were applied?

16 MR. MCKENZIE: That's correct.

17 DIRECTOR MENDELOWITZ: So that it wasn't
18 like the Home Loan Banks were trying to manipulate
19 the accounts. It was a case of very complex
20 accounting rules introduced in very recent years
21 that have created lots of problems for people as
22 they sort of sort through how to use them. If I

1 remember correctly, the FASB text explaining the
2 accounting for derivatives rule started out with
3 200 pages, and now it is over 800 pages, and it
4 grew from 200 pages to 800 pages over a 4-year
5 period.

6 So we are dealing with a very complex
7 issue here, we are dealing with the application
8 that was done with the concurrence and guidance of
9 the Big Eight or the Big Four or the Big Three
10 external auditor who was the auditor of the Banks
11 at the time, and clearly the Banks were not
12 engaged in any attempt to deliberately manipulate
13 data.

14 So the result is when all the technical
15 adjustments were made, the total restatement for
16 all those years came to \$168 million. Is that
17 correct?

18 MR. MCKENZIE: That is true, and of that
19 168, 130 of it was unrealized gain that was
20 reversed on certain for sale securities that were
21 sold the subsequent year. So on a net-net basis,
22 the \$35 million.

1 DIRECTOR MENDELOWITZ: \$35 million?

2 MR. MCKENZIE: \$35 million.

3 DIRECTOR MENDELOWITZ: So we have a net
4 adjustment after all this work on a
5 trillion-dollar balance sheet of \$35 million. Do
6 you find that a material number?

7 MR. MCKENZIE: That probably does not
8 meet the threshold standard for materiality.

9 DIRECTOR MENDELOWITZ: Going through the
10 questioning --

11 MR. MCKENZIE: Let me add that in a
12 number of cases, these adjustments at the Bank
13 level for a particular quarter did meet the
14 standard of materiality and that is why seven of
15 the Banks needed to restate financial statements.

16 DIRECTOR MENDELOWITZ: I think we
17 understand that because really what FAS-133 is all
18 about is timing. It is not a question of
19 fabricating a number, it's a question of affecting
20 which quarter a particular number gets recognized.

21 I'm going through all of this really for
22 the same reason that you took a bit of pleasure,

1 Mister Chairman, from the fact that our Banks are
2 in fact registered, and I also can't mention that
3 without recognizing the leadership that Director
4 Castaneda provided to the SEC effort. And I
5 really do believe it wouldn't have happened and it
6 wouldn't have happened as quickly were it not for
7 her sustained attention and leadership on this
8 issue.

9 I really have been sort of like going
10 back over the numbers because I want to
11 distinguish our institutions, the ones that we
12 regulate, the ones that we have been responsible
13 for regulating all along including disclosure
14 until we brought the SEC into the picture, and I
15 want to really establish on the record that these
16 institutions that we are responsible for were not
17 guilty of accounting manipulation.

18 And even when all the technical
19 adjustments were made, in the aggregate they were
20 not a material number, so that we can take great
21 confidence in the accounts of the Federal Home
22 Loan Banks as reporting their conditions under our

1 supervision and of course now with the enhanced
2 technical accuracy brought to the picture by the
3 SEC's supervision with the accounts going forward.

4 And I think the Finance Board and the
5 staff should take a lot of satisfaction in the
6 fact that when the Home Loan Banks were subjected
7 to the most rigorous and detailed scrutiny
8 possible on their accounts, came away without any
9 hint of having manipulated their data and came
10 away with accounts that required in the aggregate
11 the most marginal of adjustments and restatements
12 that were not material to the size of the balance
13 sheet.

14 CHAIRMAN ROSENFELD: Do any other
15 Directors have any comments?

16 DIRECTOR CASTANEDA: I think I told you,
17 Allen, this is a beautiful day. Good news. Thank
18 you, Joe. I just found out about it.

19 CHAIRMAN ROSENFELD: For those of you in
20 the audience, I know some of you folks work here
21 and others want to get out of the rain, but
22 anyhow, thanks for coming, and the meeting is

1 adjourned.

2 (Whereupon, at 10:16 a.m., the
3 PROCEEDINGS were adjourned.)

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